STATEMENT BY
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BEFORE THE
COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

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We are pleased to be invited to contribute to your study of Senate Bill 1527, the Civil Service Pension Reform Act, introduced July 30, 1985 by Senators Roth and Stevens. We commend your efforts to develop a Civil Service Pension System for federal workers participating in the Social Security system. The proposed Bill conscientiously seeks to contribute to the important goal of providing a sound retirement income security program for federal workers. The proposed Civil Service Pension System reflects careful consideration of the many components needed to construct such a program, including the roles of Social Security, employer-sponsored programs, individual savings programs, regulation and taxation.

You have asked us to comment specifically at this hearing on those provisions of the proposed Bill relating to the Thrift Fund. The Thrift Fund will be composed of employee and federal government contributions that require prudent investment management. The proposed Bill contains provisions for the creation of a Thrift Board, fiduciary responsibilities for those persons involved in management of funds, prohibited practices and enforcement mechanisms.

We are making this statement in our individual capacities to present our personal views as to the public interest in these matters. We are currently partners in the law firm of Arnold & Porter, Washington, D. C. We both have substantial experience with employee benefit matters and have practiced, lectured and written extensively in this field. I served as Commissioner of Social Security during the period 1978-1979.

As the Congress determined in passing the Employee Retirement Income Security Act of 1974, a comprehensive framework for a sound and stable pension program must include provisions for accountable management, standards of conduct and responsibility for fiduciaries, and appropriate sanctions, remedies and access to federal courts. The proposed Bill incorporates a number of the concepts embodied in ERISA regarding fiduciaries and enforcement. The

provisions of the proposed Bill reflect an admirable job of adapting those concepts to a plan for federal workers, a plan that is different in some respects from plans maintained by private employers and other public employers. The thrust of the Bill's provisions for a Thrift Investment Management System clearly promotes the goals of soundness, stability and accountability for the pension program. The issue as we see it is refining the proposed provisions so that they best achieve their goals.

Fiduciaries

1. The Thrift Board

The Thrift Board is to be composed of the Chairman of the Federal Reserve Board, the Secretary of the Treasury, the Director of the Office of Personnel Management and two presidential appointees that will be representatives from federal employee organizations: one from a labor organization and one from an organization for employees who are managers. The Board is to have broad and important responsibilities to establish policies and prescribe regulations for investment and management of the Thrift Savings Fund, for the administration of the Fund, for direction, supervision and performance evaluation of the Executive Director, and for the review of investment performance. The Board is expressly prohibited from directing the Executive Director

or any investment manager or other fiduciary to make a specific investment or disposition. The definition of the term "fiduciary" expressly includes the members of the Board.

The Board should execute its responsibilities in accordance with appropriate standards for accountability, however, the enforcement provisions permit civil actions by a number of interested parties for injunctions or other equitable relief in conjunction with the breach of fiduciary duties. Thus, the Board would seem subject to civil actions in connection with its authority to establish policy, prescribe regulations, appoint and oversee the Executive Director and Advisory Committee and other authority. This could lead to the federal courts being the ultimate arbiters of these matters which essentially deal with policy matters and to some extent political issues.

Thus, it is not clear that it is desirable for members of the Thrift Board to have the status of fiduciaries with respect to the Thrift Savings Fund. Although the Thrift Board should be accountable with respect to its actions in executing its broad authority to set policy for the investment and management of the Fund and the administration of the Bill's provisions relating to the Thrift Savings Plan, it may not be productive to make the Board

seem accountable through the enforcement mechanisms designed to be applicable to the fiduciaries that will implement those policies.

The Board will not be responsible for the specific transactions of the Fund that need to be scrutinized under the prohibited transaction provisions, including provisions prohibiting certain transactions with parties in interest or certain transactions giving rise to self-dealing by fiduciaries. However, the broad language of the provisions relating to the discharging of fiduciary responsibilities solely in the interest of the participants and exclusively for their benefit, and with the skill and prudence of experts, would apply to the execution of the Board's authority if the members of the Board are designated fiduciaries.

Another approach that could be considered, assuming it is deemed desirable to designate the members of the Board as fiduciaries, is to limit civil suits by participants so that the forum for resolution of potential controversies over policy matters and political issues is not the court system, but the legislative process.

The Board's accountability with respect to its duties under the Bill will normally be achieved in the legislative arena. The Congressional committees charged with the responsibility of overseeing the Board's execution of its

duties may provide an effective, yet not disruptive, forum for the communication by interested parties of their concerns. Congressional oversight is inevitable in any event, given the inherent conflict resulting from the primary enforcement responsibility under the Bill being in a department of the executive branch while primary management responsibility under the Bill will be in a group composed of other members of the executive branch.

In sum, we urge further consideration be given to the anticipated future roles of the executive branch, Congress and the courts with respect to policy matters and political issues that arise out of implementation of the new system.

2. Other Fiduciaries

Only the members of the Thrift Board and the Executive Director are expressly named as fiduciaries with respect to the Thrift Savings Fund. Other parties will have fiduciary status by reference to the definition in ERISA section 3(21)(A), based on persons having discretion or control with respect to assets, investments or administration.

It might be appropriate to name the members of the Advisory Committee as fiduciaries and to identify the persons who will perform specific management functions as fiduciaries and to define specifically the extent of their

respective responsibilities as fiduciaries. By taking these added steps, it can be made clear to what extent and with respect to what functions or assets such persons are subject to the fiduciary provisions. Although such clarification would neither expand nor contract what we think is the intended coverage of the provisions, it could serve to prevent controversy and needless litigation.

The Bill does not explicitly provide for co-fiduciary liability, an omission that, given the explicit liability set forth in ERISA, might suggest that co-fiduciaries are not liable here. We see no reason not to include in the Bill a provision similar to ERISA section 405, providing the basis for co-fiduciary liability.

Because the chains of authority and responsibility could become quite complex in the operation of the Thrift Savings Plan and Fund, the additional clarification of the scope of the fiduciary duties of various persons could serve as notice to the various fiduciaries of their relative responsibilities and could better define the scope of scrutiny at each level. Furthermore, the diversification requirement imposed on investment decisions would be susceptible to clarification in accordance with the clarification of the chain of authority and specific responsibilities of designated parties in the chain.

3. Bonding and Insurance

The Bill contemplates that a number of fiduciaries will exercise custody or control over funds in the Thrift Fund. For the protection of participants in private sector plans, ERISA section 412 requires that fiduciaries and others be bonded. Consideration should be given to imposing bonding requirements on those who will handle monies or property of the Fund, with provision for administrative exemption from or modification of the requirements similar to those set forth in ERISA section 412(e).

ERISA section 410(b) permits private sector plans to purchase insurance for liability or losses from fiduciary breaches only if the insurance permits recourse by the insurer against the fiduciary. Fiduciaries are permitted to purchase liability insurance for their own accounts. In addition, employers and employee organizations are permitted to purchase insurance to cover fiduciaries. Often, in the private sector, employers sponsoring plans purchase insurance to cover fiduciaries or indemnify fiduciaries. In many cases, such insurance or indemnification is a condition of obtaining the services of such fiduciaries.

It may be desirable to expressly permit the Executive Director to enter into arrangements that include the purchase of insurance or other means of reducing the exposure or risk

of certain contractors, in order to provide the Executive Director with a greater measure of flexibility in securing private sector services. If insurance is permitted, however, care should be taken that the Thrift Savings Fund, itself, does not bear the costs of these arrangements. In general, there may be considerable benefit to taking more detailed account of private sector experience in these matters.

Investment Policy

1. Active Investment Decisionmaking

The Bill provides guidelines for the establishment of investment policies by the Thrift Board. One such guideline directs the Board to develop policies that provide for "investment strategies which do not require a significant level of active investment decisionmaking in the case of" the Fixed Income Investment Fund and the Common Stock Investment Fund. The Board, itself, is precluded from directing the Executive Director or any investment managers or other fiduciaries to make specific investments or dispositions. While we can well understand the sentiments that underlie these provisions, it may be wise at this point to anticipate some likely areas of problems as the system is implemented.

In the case of the Fixed Income Investment Fund, under which funds are to be invested in insurance contracts, certificates of deposit or other fixed income instruments or obligations, active investment decisionmaking will be necessary on the part of investment managers if such fiduciaries are to be permitted flexibility in considering risk and return and in diversifying the investments of the Fund. The Board may find it desirable to establish policies or prescribe regulations that guide investment managers of the Fixed Income Investment Fund. Thus, the intent of the guideline regarding active investment decision-making should be clarified with respect to this specific Fund since it appears inconsistent with the realities of prudent investment management of such assets.

In the case of the Common Stock Index Investment Fund, active investment decisionmaking will not be necessary with respect to the choice of common stocks, because the Board is directed to define an index that either consists of all public stocks or is a commonly recognized index meeting certain requirements.

The Common Stock Investment Fund, however, will invest in stock carrying voting and other rights with respect to which, in the exercise of their fiduciary duties, the Fund managers will be required to engage in a significant

amount of active decisionmaking, like any prudent shareholder. In this regard, it should be recognized that in many contexts the failure to make a decision or to take an action may itself be an action with serious consequences to contending parties. Thus, there may be no way in many contexts to avoid active decisionmaking.

The experience under ERISA has included a great deal of controversy over the duties of fiduciaries with respect to stock investments. Those duties are not clear and, in many cases, in an effort to relieve the fiduciaries to the extent possible of the complex duties, private employer-sponsored plans have provided that voting rights be passed through to participants. The extent of the duties of a fiduciary under ERISA to monitor corporations and to determine whether a plan-shareholder should bring actions for breaches of corporate fiduciary duties is not a well-settled issue under ERISA.

It would seem desirable to consider these issues that have arisen with private sector plans and to define the duties of fiduciaries with respect to the Common Stock Index Investment Fund in the statutory framework in a practicable manner that will help avoid controversy and needless litigation.

2. Broad Acceptance of Investments

Another guideline for the Thrift Board's establishment

of investment policy directs the Board to develop policies that will provide for "investments likely to receive broad acceptance by participants and the public." While the sentiment that underlies this guideline is understandable, the legislative language here is extremely vague and almost certain to breed continuous controversy. For example, it would seem that under this provision the Board is entitled to establish policies that reflect to some extent "social investing."

There has been a great deal of discussion in the past several years in the context of investment policy for private sector employee plans over the extent to which plans should be permitted to make investment decisions on the basis of social factors, as opposed to purely economic calculations. For example, the Department of Labor has taken the position that a plan is not entitled to take account of the job-creating aspect of investment decisions. Commentators are divided as to whether under ERISA fiduciary decisions on investment alternatives may be based in part on such social concerns as the environment or political preferences, as opposed to solely on economic factors, such as risk management, diversification and maximization of return.

If the goal of this aspect of the legislation is to provide guidance on "social investing" in the management of

the Thrift Savings Fund, then the statutory provision should be more explicit. If some other goal is intended, the provision still appears to need clarification, preferably in the statute, but also in legislative history.

Unfortunately, as you undertake this task, the private sector experience, while rich in the elucidation of controversial issues, is poor in finding broadly acceptable solutions. This area initially may be controversial, but at least the issues should be focused in terms that allow resolution without undue controversy and needless litigation.

Prohibited Transactions

1. Parties in Interest

The definition of "parties in interest" under the Bill only adapts parts of the definition provided in ERISA section 3(14). The only omitted provision in the ERISA definition that, arguably, should be considered for inclusion in the Bill's definition is the provision defining "parties in interest" to include employees, officers, directors and 10 percent or more shareholders of persons that are parties in interest under other parts of the definition. Because the Thrift Savings Fund will be employing persons from the private sector and making investments in private sector entities and instruments, it may be appropriate to expand the definition of

"parties in interest" to include persons described in ERISA section 3(14)(H).

2. Adequate Consideration

The provisions of the Bill relating to transactions with parties in interest, unlike the corresponding ERISA provisions, do not flatly prohibit virtually all transactions with such persons. ERISA provides statutory exemptions and a procedure for administrative exemption, and was purposefully overinclusive in its efforts to protect the soundness and stability of plans. However, the "escape valve" of the administrative exemption procedure has been thought by some to be overly cumbersome.

The Bill, by contrast, would prohibit transactions with parties in interest, except when adequate consideration is exchanged. This corresponds more closely to the pre-ERISA common law standard that was regarded by some as too elusive for effective enforcement. The determination of "adequate consideration" often raises issues of fact with respect to which reasonable people might differ. Congress may believe, however, that governmental fiduciaries need not be constrained by the strict ERISA rules.

In any event, consideration might be given to defining the term "adequate consideration." Guidance might be provided, for example, by way of specific substantive

definitions in certain classes of transactions, such as transactions in commonly traded assets where comparable prices are available. Also, specific procedures might be outlined that, if followed, create a presumption that consideration is adequate, for example, obtaining independent appraisals or providing competitive bidding processes. The goal here should be to expedite investment decisions rather than to complicate such decisions because of vague requirements.

3. Fiduciary Self-Dealing

The fiduciary self-dealing provisions closely track the language in ERISA section 406(b); however, for no apparent reason, the Bill's provisions are not precisely the same as ERISA sections 406(b)(1) and (b)(2). The Thrift Savings Fund will operate in the private sector to a significant extent, and it would seem appropriate that the applicable self-dealing provisions be identical with those in ERISA to that extent.

4. Interpretation of Statutory Provisions

Because the fiduciary responsibility provisions of the Bill incorporate many concepts from ERISA, with some modifications, it may be appropriate to consider whether provisions should be included in the Bill or legislative history expressly directing that precedents under ERISA will

apply to the Bill, or pointing out that, with respect to certain provisions, specific changes from ERISA were or were not intended. It might be appropriate to include discussion of these matters more specifically in legislative history materials, so that the intent of Congress is set forth on the extent to which ERISA and related authority is or is not to be followed.

Enforcement

1. Attorney General

The Bill places primary responsibility for enforcement of the fiduciary provisions with the Attorney General of the United States. For over a decade, the Department of Labor has developed the resources, expertise and procedures for enforcing very similar provisions of ERISA. It should be considered whether efficiency and effectiveness would be better served by placing enforcement responsibility under the Bill with the Department of Labor. Greater consistency of treatment in dealing with interpretive problems would surely be achieved if a single agency had responsibility for such functions with respect to ERISA and the proposed Bill.

2. Suits by Participants

The provisions for enforcement limit civil suits by participants to actions to enjoin violations and to obtain other appropriate equitable relief to redress

violations. Under ERISA participants have access to court for disputes as to benefits and rights under a plan. Participants in the Civil Service Pension System should have some forum for resolution of disputes as to benefits and rights. Participants should be able to resort to courts whenever disputes with the administrators involve interpretations of the law and regulations.

In closing, let us commend the Committee for its important work on this subject. You are well on the way to designing the kind of regulatory provisions that are necessary to implementation of the new pension system for federal workers. Refinement of the statute and added legislative history should help you to achieve your goals in this area. If there is any way that we can contribute further to your work, we will be pleased to so do and would urge you and your staff to call upon us. We thank you for inviting us here today.